

Internal Revenue Service

memorandum

TL-N-7861-88

CC:TL:TS/MAKEYES

date: **15 AUG 1988**

to: District Counsel, Laguna Niguel W:LN
Attn: Joyce Resnick

from: Director, Tax Litigation Division CC:TL

subject: Scar Issue
[REDACTED]

This memorandum is in response to your request of July 15, 1988, for technical advice concerning the validity of the notice of deficiency issued in this case.

ISSUE

Is the notice of deficiency in this case valid under Scar v. Commissioner, 814 F.2d 1363 (9th Cir. 1987)?

CONCLUSION

This case should be conceded. Although the right adjustments were made (right amount and the right shelter), a "plug rate" was used, that rate was incorrect and therefore, the amount of the deficiency was incorrect. Furthermore, although a transcript of account was available at the time the statutory notice was prepared, not all of the information from that transcript of account was used in determining the deficiency. Although the Service is looking for the right case to defend in the Ninth Circuit, we see problems with defending this one.

FACTS

The relevant facts in this case are as follows: a "Scar" notice of deficiency was issued to taxpayers on [REDACTED], for their [REDACTED] taxable year. The notice specified a deficiency of \$ [REDACTED] arising from disallowed losses with respect to [REDACTED] and [REDACTED]. The statutory notice used the "smoking gun language" of Scar, "in order to protect the government's interest and since your original return

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is unavailable at this time, the income tax is being assessed at the maximum rate of 70%". Petitioners' losses were disallowed as a result of a list obtained from promoters of the partnerships, showing amounts and dates of investments in the partnerships. The promoters provided the list to the Service on [REDACTED], after they were convicted on charges pertaining to false partnership losses. The Laguna Niguel district was provided a list of the investors in that District on [REDACTED]. The statute of limitations for the [REDACTED] year expired after [REDACTED]. The person who prepared the statutory notice used the information from the promoters, in conjunction with the transcript of account. The only information that was taken from the transcript of account in preparing the notice of deficiency was the tax shown on the return.

DISCUSSION

This case should be conceded because the notice of deficiency is invalid under the rationale of Scar v. Commissioner, 814 F.2d 1363 (9th Cir. 1987). The Ninth Circuit found the notice of deficiency disallowing a tax shelter loss invalid since the notice was issued without examining the taxpayers' return. The Court held that in order to issue a valid notice, the Commissioner must make a "determination" as to the correct tax liability. The Court noted that a determination implies that the return has been examined, where one has been filed.

The Service does not agree with the Ninth Circuit's "substantive content" standard for testing the validity of deficiency notices under section 6212(a), although we do agree with the underlying policy concerns of the Ninth Circuit. The Service should employ adequate procedures in proposing tax deficiencies. As a result of the uncertainty of the scope of Scar, the Service wants to restrict the impact of the decision to the facts in that case. Therefore, the Service will not relitigate the "determination" issue on facts not materially distinguishable from Scar.

In Scar the following factors were present: (1) the return was not available to the office issuing the notice; (2) the notice stated that fact and contained the "smoking gun language"; (3) the tax deficiency was computed by multiplying a single adjustment by a maximum tax rate or a "plug rate" without relating the deficiency to the taxpayer's return or other return information and the notice so stated; and (4) the notice contained the wrong adjustment (e.g. misidentified partnership or tax shelter).

The Service is looking for the right case to defend in the Ninth Circuit. It is our position that the Service does not have to have the original return to determine a deficiency, but that we can use information from the Service's data bases. See LGM TL-3, The "Determination" Requirement for Statutory Notice of Deficiency under I.R.C. § 6212(a); Scar v. Commissioner, 814 F.2d 1363 (9th Cir. 1987), rev'g 81 T.C. 855 (1983). The ideal case to defend in the Ninth Circuit would be one where the notice contained the Scar language, the right adjustment was made (including right amount) and the right rate was used. Furthermore, the transcript of account was used to figure out the deficiency, as compared to "backing into" the correct rate. For example, on the notice of deficiency, the Form 4549-A Income Tax Examination Changes, if the sheet shows not only the tax shown on the return, but also shows adjusted gross or taxable income shown on the return, we feel we can make a strong argument that a "determination" was made without actually having the return. All of this information would have been obtained from information on the return, but would actually be pulled from IRS data bases.

In this case, although the right adjustments were made (correct shelter, right amount of disallowed loss), the taxpayers were not in the 70% tax bracket, rather they were in the [REDACTED]% tax bracket for the [REDACTED] year. If we had used all the information that was available to us on the transcript of account, such as taxable income shown on return, we could have determined the correct rate and a stronger argument could be asserted that we made a "determination". The only information that was pulled from the transcript of account was the tax shown on the return. By taking the adjustments of the disallowed losses, taxing them at a 70% rate and then subtracting the tax shown on the return, the deficiency of \$[REDACTED] was determined. The taxpayers were actually in a [REDACTED]% tax bracket and the actual deficiency should have been around \$[REDACTED]. As a result, an incorrect deficiency was determined. If we had used the information from the transcript of account, i.e. taxable income shown on the return, then a correct rate could have been determined (particularly, in this case since there was no personal service income involved) from which the correct deficiency could also have been determined.

Based upon these factors we do not recommend defending this case which is appealable to the Ninth Circuit. This notice would, however, be defended in any other Circuit.

Should you have any further questions regarding this memorandum, please contact Marsha Keyes, Tax Shelter Branch at FTS 566-4174.

MARLENE GROSS

By:



PAMELA V. GIBSON
Acting Branch Chief,
Tax Shelter Branch